

REPORT OF EXAMINATION
OF THE

AMERICAN HOME
SHIELD OF CALIFORNIA, INC.

AS OF
DECEMBER 31, 2003

Filed June 22, 2005

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San Francisco, California
March 12, 2005

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of

AMERICAN HOME SHIELD OF CALIFORNIA, INC.

(also referred to as the Company) at its main administrative and statutory home office located at 889 Ridge Lake Boulevard, Memphis, Tennessee 38120.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2000. This examination covers the period from January 1, 2001 through December 31, 2003. The present examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions, and an evaluation of assets and a determination of liabilities as of December 31, 2003, as deemed necessary under the circumstances.

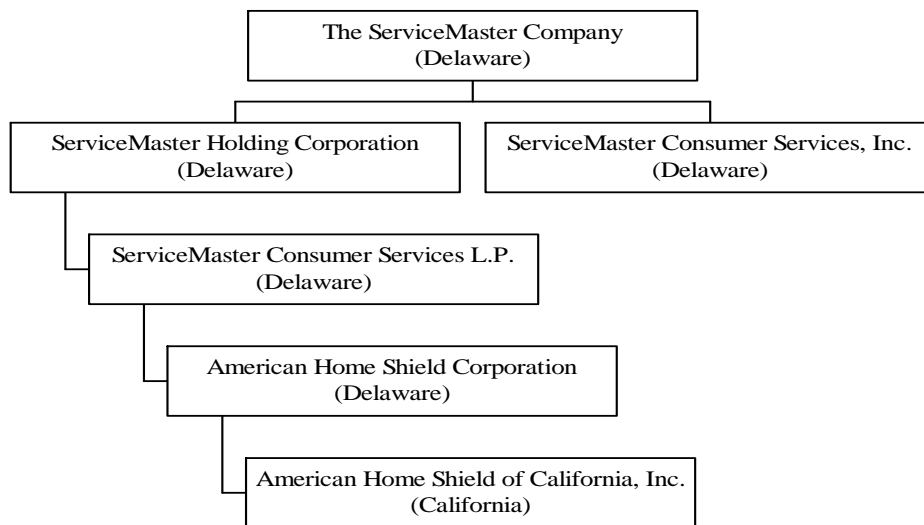
In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: corporate records; fidelity bonds and other insurance; employees' and agents' welfare and pension plans; growth of company; business in force by states; loss experience; and sales and advertising.

COMPANY HISTORY

During the period of this examination, the Company declared and paid dividends to its parent, American Home Shield Corporation, in the amounts of \$9.5 million in 2003, \$7 million in 2002 and \$5 million in 2001.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which The ServiceMaster Company, a Delaware corporation, is the ultimate controlling entity. The following chart depicts the interrelationship of the Company within the holding company system as of December 31, 2003 (all ownership is 100%):



Management of the Company is under the control of a sole (one)-member board of director(s) and the officers of the Company. The director and principal officers as of December 31, 2003 were as follows:

Director

Name and Residence

Scott J. Cromie
Germantown, Tennessee

Principal Business Affiliation

President and Chief Executive Officer
American Home Shield Corporation

Principal Officers

Name

Scott J. Cromie
Brian L. Rupiper
Mark F. Lightfoot
David J. Crawford
Richard A. Ascolese

Title

President and Chief Executive Officer
Vice President, Finance and Treasurer
Secretary
Vice President of Sales
Assistant Secretary

Intercompany Tax Allocation Agreement

The Company is included in the consolidated federal income tax return of its immediate parent company, American Home Shield Corporation (AHSC). Taxes are allocated in accordance with the Company's Tax Sharing Agreement dated August 19, 2000 and the Internal Revenue Code (IRC) Section 1522(a)1, which apportions the tax liability among the members of the group in accordance with the ratio of the consolidated taxable income attributable to each member of the group having taxable income bears to the consolidated taxable income. The Company did not list the August 2000 Tax Sharing Agreement in its 2001, 2002 and 2003 Form B filings per California Insurance Code (CIC) Section 1215.4. It is recommended that the Company submit the tax allocation agreement to the California Department of Insurance (CDI) for review in compliance with CIC Section 1215.4. (b).

Additionally, the Company's parent, AHSC, received a \$607,559 refund as a result of an IRS audit of AHSC and subsidiaries for the tax years 2000, 2001 and 2002. The refund was not allocated to the AHSC subsidiaries in accordance with the tax agreement. This treatment was not pursuant to the AHSC 2000 Tax Sharing Agreement, paragraph 9, nor fair and reasonable per CIC Section 1215.5(a). It is recommended that the Company recalculate the tax liability to fairly

allocate IRS refunds per the August 2000 Tax Sharing Agreement and CIC Section 1215.5(a) when tax refunds are received for AHSC and subsidiaries.

Intercompany Management Agreement

AHSC manages the Company's home warranty business, which includes collecting contract fees, issuing home protection contracts, paying expenses, settling claims, performing accounting functions and filing regulatory reports. All expenses, except federal income tax expense, are paid by AHSC and settled through inter-company accounts. The Company is to bear its equitable share of pooled overhead expenses actually incurred and reported in AHSC. Equitable share is based on the Company's percentage of home protection contracts written in AHSC during the accounting period.

Conflict of Interest

The Company has an established procedure whereby its directors and officers annually disclose, via questionnaire, any actual or potential conflicts of interest. During the review of 2002 and 2003 conflict of interest statements it was noted that the conflict of interest statements were not signed by the director and two key employees of the Company. It is recommended that the Company's conflict of interest procedures be completed by key employees.

TERRITORY AND PLAN OF OPERATION

The Company is licensed to issue home protection contracts in the State of California only. The Company issues service contracts on a direct basis using American Home Shield Corporation employees, as sales representatives, for production and marketing. The Company uses independent Company approved building contractors throughout California for servicing claims, subject to the oversight and monitoring by the Company's staff. Approximately 39 employee sales-representatives are utilized by the Company. The Company also utilizes a branch office located in Santa Rosa, California. The branch maintains a regional sales office and call center. The Company also uses third party administrators for the collection and reporting of warranty payments. The net contract fees written in California totaled \$99.2 million in 2003.

REINSURANCE

The Company did not assume or cede reinsurance during the period covered by this examination.

ACCOUNTS AND RECORDS

The Company recorded a \$5,349,391 permanent common stock impairment as a surplus adjustment. The permanent impairment should have been recorded in the income statement as a realized loss per SSAP 30, paragraph 9. The overall effect of the improper classification had no effect on surplus, and therefore, no examination adjustment was made. It is recommended that the Company report permanent impairments in the income statement per SSAP 30, paragraph 9.

The Company has not properly reported changes in net deferred income tax in surplus adjustments. The Company reported a change in surplus for deferred income taxes in its 2002 Annual Statement. In the 2003 Annual Statement the change in net deferred income tax is not reported and the amount reported in the 2002 Annual Statement is not reflected for the previous year. The Company reported the previous year's change in net deferred income tax in the unrealized gains/losses section. It is recommended that the Company review SSAP 10 reporting procedures to ensure that its official filings to the California Department of Insurance and other regulatory agencies are complete and accurate

During the course of the examination, a review was made of the Company's general controls over its information systems. As a result of this review, weaknesses were noted in areas such as logical and physical security controls and planning controls. The weaknesses were presented to the Company along with recommendations to strengthen its controls. The Company should evaluate the findings and recommendations and make appropriate changes to strengthen its information systems controls.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2003

Underwriting and Investment Exhibit for the Year Ended December 31, 2003

Reconciliation of Surplus as Regards Contract Holders from December 31, 2000
through December 30, 2003

Statement of Financial Condition
as of December 31, 2003

	<u>Ledger and Nonledger Assets</u>	<u>Assets Not Admitted</u>	<u>Net Admitted Assets</u>	<u>Notes</u>
<u>Assets</u>				
Bonds	\$ 16,935,461	\$	\$ 16,935,461	(1)
Common stocks	50,189,318		50,189,318	(1)
Cash and short-term investments	12,575,065		12,575,065	(1)
Other invested assets	3,227,977		3,227,977	(1)
Home protection contract fees in course of collection	16,600,243	1,401,622	15,198,621	
Service fees receivables	425,403	145,730	279,673	
Interest, dividends and real estate income due and accrued	334,955		334,955	
Inventory	57,045	57,045		
Deferred tax asset	<u>1,718,150</u>	<u></u>	<u>1,718,150</u>	(2)
Total assets	<u>\$102,063,617</u>	<u>\$ 1,604,397</u>	<u>\$100,459,220</u>	
<u>Liabilities, Surplus and Other Funds</u>				
Claims adjusted and unpaid or in process of adjustment			\$ 5,016,867	
Claims service expense			100,000	(3)
Other expenses			550	
Taxes, licenses and fees			69,128	
Federal income taxes			8,284,393	
Unearned home protection contract fees			40,062,441	
Payable to affiliates – Deferred federal income tax due			<u>5,279,800</u>	
Total liabilities			58,813,177	
Common capital stock		\$ 1		
Gross paid-in and contributed surplus		6,442,857		
Unassigned funds (surplus)		<u>35,203,183</u>		
Surplus as regards contract holders			<u>41,646,041</u>	
Total liabilities, surplus and other funds			<u>\$100,459,220</u>	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2003

Statement of Income

Underwriting Income

Home protection contract fees earned		\$ 98,888,124
Deductions:		
Claims incurred	\$ 47,228,203	
Claims service expenses incurred	8,599,621	
Other expenses incurred	<u>20,800,517</u>	
Total underwriting deductions		<u>76,628,341</u>
Net underwriting gain		22,259,783

Investment Income

Net investment income earned	\$ 1,400,353	
Net realized capital gains	<u>3,479,193</u>	
Net investment gain		<u>4,879,546</u>
Net income before federal income taxes		27,139,329
Federal income taxes incurred		<u>6,566,243</u>
Net income		<u>\$ 20,573,086</u>

Capital and Surplus Account

Surplus as regards contract holders, December 31, 2002		\$23,786,042
Net income	\$ 20,573,086	
Permanent impairment	(5,349,391)	
Change in nonadmitted assets	6,659	
Dividends to stockholders	(9,500,000)	
Net change in unrealized gain on equity securities	<u>12,129,645</u>	
Change in surplus as regards contract holders		<u>17,859,999</u>
Surplus as regards contract holders, December 31, 2003		<u>\$41,646,041</u>

Reconciliation of Surplus as Regards Contract Holders
from December 31, 2000 through December 31, 2003

Surplus as regards contract holders, December 31, 2000, per Examination			\$31,232,759
	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>	
Net income	\$35,124,744	\$	
Change in net unrealized capital gains	157,499		
Change in nonadmitted assets		31,206	
Surplus adjustments: Codification		1,592,742	
Prior Year open contract fees		1,745,013	
Dividends to stockholders (cash)	_____	<u>21,000,000</u>	
Total gains and losses	<u>\$35,282,243</u>	<u>\$24,868,961</u>	
Increase in surplus as regards policyholders			<u>10,413,282</u>
Surplus as regards contract holders, December 31, 2003, per Examination			<u>\$41,646,041</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Bonds, Common Stocks, Cash and Short-Term Investments, and Other Invested Assets

The custodial agreements between the Company and Union Bank and the Company and the Mechanics Bank do not meet the California Department of Insurance's (CDI) standard of approval. The custodial agreements between the Company and Union Bank are in respect to investments managed by the Bank of New York and Schaffer Cullen Management. Also, the custodial agreement used by Schaffer Cullen Management lists Jurika and Voyles as the investment manager. Additionally, the custodial agreements were not submitted the CDI as required by California Insurance Code Section 1104.9. The Company should amend the agreements to meet the standards and submit them to the CDI for review and approval. A similar comment was also made in the prior report of examination.

The Company records securities based on the settlement date and not the trade date as required by SSAP 21, paragraph 6. The overall financial effect from the improper recordings of the securities was \$526,927 and is not considered material. Therefore, no examination adjustment was made. However, it is recommended that the Company review transactions pending at year-end to ensure proper recording of sales/purchases per trade date as prescribed by SSAP No.21, paragraph 6.

The Company reported in its Annual Statement 'Other invested assets' which consist of U.S. Government backed-mortgage securities reported at market value. It is recommended that the Company reclassify these securities as "Bonds" and carry them at their amortized value. This comment was also made in the prior report of examination.

(2) Deferred Tax Asset

The Company's deferred tax asset at December 31, 2003 was overstated by approximately \$790,000, however no examination adjustment was made to the Company's financial statements as the overstatement is not considered material. The Company did not offset the deferred tax

asset with the deferred tax liability per SSAP 10. paragraph 5. It is recommended that the Company comply with SSAP 10, especially paragraphs 5-7 for proper recording of deferred tax assets.

(3) Claims Service Expense

The Company's practice is to report a \$100,000 reserve for its claims service expense in the Annual Statements reports. The Company, however, was unable to provide supporting documentation or the basis for establishing the amount of claims expense reserve. It is recommended that the Company evaluate this reserve and establish its claims expense reserve based on reliable and defensible methods. This comment was also made in the prior report of examination.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Intercompany Tax Allocation Agreement (Page 3):

1. It is recommended that the Company submit the tax allocation agreement to the California Department of Insurance (CDI) for review in compliance with California Insurance Code (CIC) Section 1215.4. (b).
2. It is recommended that the Company recalculate the tax liability to fairly allocate IRS refunds per the August 2000 Tax Sharing Agreement and CIC Section 1215.5(a) when tax refunds are received for American Home Shield Corporation and subsidiaries

Management and Control - Conflict of Interest (Page 4): It is recommended that the Company's conflict of interest procedures be completed by key employees.

Accounts and Records (Page 5): It is recommended that the Company report permanent impairments in the income statement per SSAP 30 paragraph 9.

Accounts and Records (Page 6): It is recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information systems controls.

Comments on Financial Statement Items - Bonds, Common Stocks, Cash and Short-Term Investments, and Other Invested Assets (Page 10):

1. It is recommended that the custodial agreements between the Company and Mechanics Bank and the Company and Union Bank, in respect to investments managed by the Bank of New York and Schaffer Cullen Management, be amended to meet the CDI standards and submit them to the CDI for review and approval per CIC Section 1104.9
2. It is recommended that the Company review transactions pending at year end to ensure proper recording of sales/purchases per trade date as prescribed by SSAP No.21, paragraph 6.
3. It is recommended that the Company reclassify the Government backed mortgage securities from "Other invested assets" to "Bonds" and carry them at their amortized value.

Comments on Financial Statement Items - Deferred Tax Asset (Page 10): It is recommended that the Company comply with SSAP 10, especially paragraphs 5-7 for recording and reporting deferred tax assets.

Comments on Financial Statement Items - Claims Service Expense (Page 11): It is recommended that the Company evaluate this reserve and establish its claims expense reserve based on reliable and defensible methods.

Previous Report of Examination

Management and Control - Conflict of Interest (Page 4): It was recommended that the Company's conflict of interest procedures be extended to key employees. The Company has not complied with this recommendation.

Accounts and Records (Page 4): It was noted that the Company did not provide adequate supporting documents for some accounts. The Company should evaluate its records retention procedures to ensure proper maintenance and retention of records. The Company has complied with this recommendation.

Accounts and Records – Information Systems Controls (Page 6): It was recommended that the Company evaluate the recommendations and make appropriate changes to strengthen its information systems controls. The Company is in the process of complying with the recommendations.

Comments on Financial Statement Items - Bonds, Common Stocks and Other Invested Assets (Page 11): It was recommended that the Company obtain approval from the CDI for the custodial agreement in respect to investments managed by Jurika and Voyles, pursuant to CIC 1104.9. The Company is currently using this agreement for another investment manager. The Company has not complied with this recommendation.

Comments on Financial Statement Items - Home Protection Contract Fees Receivable and Service Fees Receivable (Page 11): It was recommended that the Company review its records retention policy. The Company has complied with this recommendation.

Comments on Financial Statement Items - Claims Adjusted and Unpaid or In Course of Adjustment and Claims Service Expense (Page 11): It was recommended that the Company analyze the reasons for the deficiency in its claims reserve and adjust its reserving methodology if necessary. It was also recommended that the Company evaluate the claims expense reserve and establish it based on reliable and defensible methods. The Company has not complied with these recommendations.

ACKNOWLEDGEMENT

Acknowledgement is made of the cooperation and assistance extended by the officers and employees of the Company during the course of this examination.

Respectfully submitted,

/S/

Sandra K Bailey, CFE
Associate Insurance Examiner
Examiner-In-Charge
Department of Insurance
State of California